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Capital One®

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Manager
Dissemination Branch
Information Management and Services Division
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

Re: Proposed Agency Information Collection Activities: Comment Request

Ladies and Gentlemen:

Thank you for the opportunity to comment on the above-referenced proposal. This comment letter is submitted on behalf of Capital One Financial Corporation, Falls Church, Virginia ("Capital One"), and its wholly-owned thrift subsidiary, Capital One Federal Savings Bank, Falls Church, Virginia ("Capital One F.S.B."), in response to the proposal ("Proposal") to revise the Thrift Financial Report (the "TFR"), OMB Number 1550-0023, to collect certain additional information intended to make the content of the reports more relevant to the agency. This comment letter will focus principally upon one element of the Proposal: the OTS' request for new information on "nontraditional lending" activities, including so-called "subprime" loans.

Capital One is a holding company whose subsidiaries provide a variety of products and services to consumers. The principal subsidiaries of Capital One are Capital One Bank, which offers credit card products, and Capital One, F.S.B., which offers consumer lending products, including credit cards, and deposit products. Capital One has approximately 27 million accounts and $21 billion in managed consumer loans outstanding, and is one of the world's largest providers of MasterCard and Visa credit cards.

SUMMARY

Capital One believes that a single definition of "subprime loan," based upon the broad criteria outline in the Proposal, is unworkable and ill-advised. As the Proposal itself acknowledges, the "quality and validity of the proposed subprime information to be collected in the TFR hinges on a workable definition of subprime lending" 65 Fed. Reg. 48051. As such, a definition that falls short of this standard would be of little benefit to regulators, the industry or consumers.

Capital One believes that any agency or industry assessment of what constitutes "subprime" lending should remain fluid and based upon discrete variables. As discussed more fully below, Capital One has successfully managed risk through sophisticated segmentation and modeling, mitigating the abuses that have spurred recent increases in regulatory scrutiny. As such, greater "consistency" or "standardization" in risk classifications, which the proposed definition and increased reporting of subprime lending activity purports to achieve, would in reality represent a "lowering of the bar" for institutions such as Capital One that employ risk models and classifications far in excess of current industry standards.

In addition, the implications for consumers of an overly-broad definition of subprime lending are particularly significant. In the Proposal, the OTS states that subprime borrowers represent a broad spectrum of debtors. While acknowledging that the lines delineating categories of borrowers are unclear, such a statement appears to support the casting of a wide net, using the TFR reporting process to label large numbers of borrowers, and the institutions that serve them, as "subprime." By seeking to focus substantial regulatory scrutiny on one segment of the credit spectrum, the Proposal inevitably will foster unduly negative perceptions regarding this lending activity. The potential implications of such perceptions may compel traditional lenders to minimize that portion of their portfolio dubbed "subprime," thereby denying many worthy borrowers access to needed credit products from mainstream channels.

Capital One believes that relying on the TFR would generalize, and therefore diminish, the quality of information received by eliminating the ability of the OTS to consider individual factors relevant to each institution's lending activities. Those institutions most capable of successfully managing risk assess borrowers based upon criteria appropriate to their particular circumstances. What a regulatory agency may consider "subprime" for general reporting purposes may not be an appropriate label for an individual consumer based upon a more sophisticated risk analysis. In this regard, any attempt to achieve a standardized definition of "subprime" likely would fail to achieve its stated purpose of bringing increased clarity to the current credit landscape. As such, Capital One believes that the Proposal would not assist the OTS in painting a more accurate portrait of the true scope of a particular institution's subprime lending activity.

DISCUSSION

The Proposal

The Proposal characterizes so-called subprime lending as a "high-risk activity that poses increased risk to the institutions involved and to the deposit insurance funds if appropriate safeguards are not in place." 65 Fed. Reg. 48050. The OTS contends that there is currently no reliable way to regularly monitor individual institutions' subprime lending programs. Accordingly, the OTS is proposing to add a number of new items to the TFR relating to subprime lending. It is the OTS' hope that these proposed items would make possible the early detection and proper supervision of subprime lending programs through offsite monitoring procedures. Thrifts involved in subprime lending would report, *inter alia*, quarter-end data for the following categories of subprime loans in their loan portfolios: "(5) credit cards to individuals for household, family, and other personal expenditure, (6) consumer loans secured by automobiles, (7) other consumer loans, and (8) other subprime loans."

Notably, the Proposal recognizes that the "quality and validity of the proposed subprime lending information to be collected in the TFR hinges on a workable definition of subprime lending." 65 Fed. Reg. 48051. The Proposal states that "subprime loans could be defined on the basis of either (a) loan portfolios or programs that possess certain characteristics, or (b) individual loans with these characteristics." *Id.* Whether the portfolio or program approach or the individual loan approach ultimately is adopted, the OTS is proposing the following definition of subprime loans for purposes of reporting information on these loans in the TFR:

> *Subprime loans are extensions of credit to borrowers who, at the time of the loan's origination, exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. Risk of default may be measured by traditional credit risk measures, e.g., credit/repayment history and debt-to-income levels, or by alternative measures such as credit scores. Subprime borrowers represent a broad spectrum of debtors ranging from those who have exhibited repayment problems prior to origination of their loans due to an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime lending does not include loans to borrowers who have had minor, temporary credit difficulties since the origination of their loans but are now current. Subprime loans may take the form of direct extensions of credit; loans purchased from other lenders, including delinquent or credit impaired loans purchased at a*

discount; and automobile or other financing paper purchased from other lenders or dealers. Id.

Subprime Lending

The issue of subprime lending has garnered significant recent attention within the financial services community -- from regulators, consumers, the media and the institutions, themselves. While the term "subprime" is most often used generically to describe low-income borrowers, it remains a largely undefined consumer risk categorization that can, in some instances, encompass an overly-broad segment of the population. While some observers fault the lack of a standard regulatory or market definition of "subprime," in truth, this uncertainty reflects the significant difficulty in applying a single, workable label to consumers within particular income brackets or credit score ranges. In fact, Capital One's own experience and research indicate that customers who might be categorized as "subprime" actually look very similar to "prime" customers with respect to education, employment and income.

As such, subprime lending has become an often misunderstood activity, which has, in some instances, been equated unfairly and improperly with "predatory" lending. A failure to distinguish between these practices, however, does a grave disservice to legitimate financial institutions who choose to make credit available to low-income borrowers, including many minorities, or borrowers with damaged or incomplete credit histories, who have historically been denied access to mainstream financial services. "Predatory" lending, on the other hand, refers to abusive lending practices conducted by companies on the fringe, or completely outside the scope, of legitimate financial services providers, where vulnerable consumers are forced to accept onerous, unreasonable or even borderline fraudulent terms in order to obtain credit.

Prior to any reasonable discussion of subprime lending, it is vital to recognize that not all low-income borrowers represent a high credit risk and not all high-income borrowers represent a low credit risk. Broad generalizations based on a limited number of criteria can provide at best, limited, and at worst, inaccurate, understandings of the true credit risk posed by an individual consumer. Lenders manage risk at the beginning, middle and end of the customer relationship by providing properly designed products and ensuring that the customer continues to be able to responsibly use that product. In fact, industry history is replete with examples of lenders focusing exclusively upon -- and losing money on -- so-called "prime" and "superprime" customers in mortgage, credit card and other lending sectors. From 1995-1997, for example, numerous lenders over-issued prime loans in the credit card sector, and have been exiting the business entirely since that time.

Capital One's Approach to Customer Acquisition, Retention and Risk Assessment

As the discussion below will explain, for financial institutions such as Capital One who utilize highly sophisticated and proprietary risk modeling processes, numerous factors go into developing an individual customer's risk profile.

Capital One's success in attracting customers and managing risk is based upon constant innovation generated by its proprietary Information Based Strategy ("IBS"). IBS enables the company to use information and market testing to deliver the right product to the right customer at the right price at the right time. Thousands of product and service tests are conducted each year, and the results are analyzed in order to "mass-customize" product offerings to the consumer marketplace. This extensive learning is possible because of highly flexible in-house systems and processes, and the close integration of operations, marketing and information technology efforts.

Capital One applies IBS to all areas of its business, including solicitations, account management, credit line management, pricing strategies, usage stimulation, collections, recoveries and account and balance retention. Capital One uses IBS to differentiate among customers based on credit risk, usage and other characteristics, and to match customer characteristics with appropriate product offerings. IBS involves developing sophisticated models, information systems, well-trained personnel and a flexible culture to create product and services that address the demands of changing consumer and competitive markets. By actively testing a wide variety of product and service features, marketing channels and other aspects of offerings, Capital One designs customized solicitations that are targeted at various customer segments, thereby enhancing customer response levels and maximizing returns on investment within given underwriting parameters.

Credit Risk Modeling

Capital One notes that the Proposal's definition of "subprime" loans refers to "extensions of credit to borrowers who, *at the time of the loan's origination*, exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers" *Id.* (emphasis added). This proposed definition does not appear to take into account the ability of borrowers to improve their credit ratings over time. For example, while a particular customer may be considered a high credit risk as a student or recent entrant into the workforce, over the life of their account, they may exhibit positive account growth characteristics, such as increased income or an unblemished payment history, that may warrant a reclassification of their risk level and a corresponding increase in their credit line.

Capital One uses various techniques to evaluate credit risk and determine whether to accept a particular customer. These techniques also allow Capital One to determine the appropriate credit limit for a customer, according to the risk profile developed. Capital One builds on information derived from initial sources with continued integrated testing and model development to improve the quality, performance and profitability of its solicitation and account management initiatives. In this regard, Capital One has built proprietary risk models and scorecards based on application data, purchase transaction data, and payment and utilization data, as well as incorporating generic information obtained from third-party credit bureaus. Its scorecard parameters for application decisions and credit line assignments vary with product offerings, channels and market conditions. These parameters are based on a combination of statistically derived modeling techniques, judgement, and testing methodology approved by its credit committee. Capital One constantly reevaluates its scorecard cuts, as well as the success of its models.

Capital One also periodically reviews its portfolio to select accounts that qualify for an increase in credit limit, or other change in credit terms. The decision to extend additional credit, or to change the terms of that credit, is based upon a favorable trade-off between predicted risk and utilization. Predictions for both of these variables are made using statistical modeling techniques that combine information from credit bureaus with that contained in Capital One's proprietary card database. Scores are calculated monthly to assess the risk of existing customers, and are used for proactive credit limit and terms programs. Results of the credit management process are benchmarked against published industry sources such as Fair Isaac, VISA and MasterCard.

Unlike other lenders who rely entirely on a generic FICO score to determine a customer's credit worthiness, Capital One utilizes an evolving, customized scoring system that provides a far more accurate picture of an individual customer's credit profile. In this regard, Capital One's risk modeling recognizes that an individual customer's circumstances may change dramatically over the course of their account relationship with the company, warranting migration of that customer out of one risk category and into another. Capital One believes that dependence on credit scores that represent a mere "snapshot-in-time" provide poor predictors of actual risk.

Notably, Capital One's credit models do not produce a static number, but rather, an index continuously reevaluated and recalculated over time. Thus, a customer who may be considered "subprime" at the time of an account's origination may reveal themselves to be a substantially lower credit risk as their account ages.

More Sophisticated Scoring Reduces Credit Risk

Through utilization of a multi-level process, Capital One is able to be far more selective in its marketing across the credit spectrum than many of its competitors.

Lenders who rely principally, or even entirely, upon FICO scores and other generic rating systems may solicit and accept customers who Capital One, based on its own analysis of potential risk, may choose not to target. Capital One's increased selectivity, therefore, helps to maintain the overall health of its credit portfolio by avoiding or minimizing many of the risks assumed by institutions with less effective risk modeling capabilities.

More Sophisticated Scoring Provides Consumer Benefits

Greater accuracy in risk modeling provides not only a better predictor of credit risk to the institution, but also helps to ensure that a customer will be offered a product most suitable to their needs. Conversely, institutions who favor strict adherence to FICO scores, or similar ratings, are more likely to lump large numbers of individual customers into broad categories labeled "prime" or "subprime," a practice seemingly encouraged by the Proposal's approach to defining subprime lending. This latter practice would likely result in a return to widespread credit discrimination against consumers whose generic bureau data may support a high risk classification, but who may, upon deeper analysis of their particular circumstances, actually be an acceptable credit risk. A "one-size-fits-all" approach to credit categorization reduces consumer choice and discourages legitimate financial institutions from seeking creative ways to meet the credit needs of the broadest possible range of consumers.

Conclusion

Through use of its highly sophisticated, proprietary risk modeling technology, Capital One possesses the ability to acquire and manage credit card accounts tailored to the needs of its individual customers. Capital One offers and supports the broadest product menu in the credit card industry, from platinum cards to "entry-level" programs. This strategy permits Capital One to offer credit to a wider range of customers than its competitors and to approve and satisfy more customers, while still managing risk to industry leading standards. As a result, despite its status as a full-spectrum credit card lender, Capital One's charge-off rate consistently ranks as or among the lowest in the industry.

Capital One believes that this "mass customization" approach eschews broad categorization and defies overly-simplistic delineation and labeling of customers at isolated points in their credit history. As such, Capital One does *not* support the adoption of a standardized definition of subprime lending that would have the effect of hampering the company's ability to evaluate and categorize risk utilizing its own internal models – models which comprise a level of data analysis far in excess of common industry practice.

While Capital One appreciates the OTS' desire to achieve greater efficiency in the reporting of subprime lending activity through increased collection of data in the TFR, the company believes that the Proposal would have the effect of: (i) mischaracterizing true credit risk, from both a supervisory and market perspective; (ii) reducing the benefits of competition by forcing many traditional lenders to restrict their presence in this market; and (iii) and ultimately harming consumers and the institutions that serve them. In addition, the breadth of information sought in this regard would substantially increase the reporting burden for many financial institutions, while achieving no significant public benefit.

The OTS should not be seeking to strip lending institutions of their ability to most accurately assess the credit worthiness of their customers. Lending institutions such as Capital One utilize discretion to avoid lumping consumers into generic risk categories. Conversely, the Proposal runs the risk of creating a single, overly-broad designation of what constitutes "subprime lending." In addition to compromising the ability of financial institutions to evaluate risk on an individual basis, such a designation could have the unintended consequence of unfairly categorizing many consumers as "subprime," thereby discouraging lenders from marketing to this segment of the population for fear of potential regulatory and market consequences.

* * *

Capital One appreciates this opportunity to comment on the Proposal. If you have any questions concerning these comments, or if we can otherwise be of assistance in connection with this matter, please do not hesitate to contact me at (703) 875-1480.

Sincerely,

Andres L. Navarrete
Assistant General Counsel